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MEMORANDUM

TO: Ed Cebron, FCSG, Inc.

FROM: Hugh Spitzer

DATE: October 21, 1996

RE: Interim Water Group: Inclusion of Costs for Future Capital Facilities in City Facilities Charges

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A key financing element of the proposed regional water system being considered by the Interim Water Group ("IWG") is a component to each jurisdiction's "capital facilities charge" (or "system development charge") that would reflect the allocable cost of each new retail hook-up to the regional supply system. That component of each capital facilities charge, collected by a participating local government, would be passed on to the regional water entity and would be used to provide for part of the cost of developing water supply facilities to serve that new customer.

You have inquired concerning the legal authority of cities and water districts to include, in their capital facilities charge, such a component reflecting the cost of the future construction of water supply facilities.

As detailed below, we are of the opinion that both cities and water districts have ample authority to include the cost of future facilities so long as the impact of each new customer is clearly documented by engineers and/or financial consultants and the local utility expressly relies on professional studies by those engineers or consultants in adopting that component of the capital facilities charge.

As described below, the ability of water districts to include future costs in capital facilities charges is limited to ten years of projected costs. Consequently, if a new entity for water supply is formed by an interlocal agreement that contemplates the inclusion of a future capital facilities component in all of those municipalities' capital facilities charges, cities may be effectively limited to the same ten-year financing horizon that applies to water districts. The IWG may wish to seek legislation that would increase the permitted capital facilities planning period to twenty years, the period used for certain Growth Management Act purposes.

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RELEVANT STATUTES

RCW 35.92.025 states, in part:

> Cities . . . are authorized to charge property owners seeking to connect to the water . . . system of the city . . . as a condition to granting the right to so connect, in addition to the cost of such connection, such reasonable connection charge as the legislative body of the city . . . shall determine proper in order that such property owners shall bear their equitable share of the cost of such system. The equitable share *may* include interest charges applied from the date of construction of the water . . . system until the connection, or for a period not to exceed ten years . . . PROVIDED, That the aggregate amount of interest shall not exceed the equitable share of the cost of the system allocated to such property owners."

(Emphasis added). A separate statute, RCW 35.92.020, lists types of factors that a city may take into account when setting rates or service. Although rates are different from hook-up fees, Washington court decisions imply that these types of factors must be taken into account when determining non-rate charges such as capital facilities charges. RCW 35.92.010 states, in part,

> "[T]he rates charged must be uniform for the same class of customer service. . . . In classifying customers served or service furnished, the city . . . governing body may in its discretion consider any or all of the following factors: The difference in cost of service to the various customers; location of various customers within and without the city . . .; the difference in cost of maintenance, operation, repair, and replacement of the various parts of the system; the different character of the service furnished various customers; the quantity and quality of the water furnished; the time of its use; the achievement of water conservation goals and the discouragement of wasteful water use practices; capital contributions made to the system, including, but not limited to, assessments; and any other matters which present a reasonable difference as a ground for distinction. No rate shall be charged that is less than the cost of the water and service to the class of customer served.

The statute relating to rate making powers of sewer and water districts contains similar language. RCW 57.08.010(3) states, in part:

> (3) A water district . . . may charge property owners seeking to connect to the district's water supply system, as a condition to granting

> the right to so connect, in addition to the cost of such connection, such reasonable connection charge as the board of commissioners shall determine to be proper in order that such property owners shall bear their equitable share of the cost of such system.
>
> (a) For purposes of calculating a connection charge, the board of commissioners shall determine the pro rata share of the cost of existing facilities and facilities planned for construction within the next ten years and contained in an adopted comprehensive plan and other costs borne by the district which are directly attributable to the improvements required by property owners seeking to connect to the system. The cost of existing facilities shall not include those portions of the system which have been donated or which have been paid for by grants.

(After July 1, 1997, this section is revised and recodified at RCW 57.08.005(9)).

DISCUSSION

It has been suggested that the fact that water districts have express authority to include ten years of future facilities costs in connection charges means that cities do not have that authority. Cities lack an express reference in statute. However, Washington courts have upheld the ability of governmental utilities to include future costs in the determination of future capital costs in the determination of connection charges when no express grant existed. The leading case in this regard is Hillis Homes v. Public Utility Dist. No. 1 of Snohomish County, 105 Wn.2d 288 (1986) ("Hillis II"). In Hillis II, the court noted that the Snohomish County Comprehensive Plan projected rapid growth that would need to be served by infrastructure improvements. The Public Utility District ("PUD") undertook a long range plan which included, according to the court opinion, a "detailed computer model of all the components of the existing water system." 105 Wn.2d at 291. That model projected the demands of new customers and identified the improvements and the costs necessary to serve the expansion area. The court noted that if growth had not occurred then the new systems would not be needed, and that the PUD had used a "proportionate share analysis" in developing its general facilities charge so that only the cost of those improvements that would serve new customers would be allocated to them. The court mentioned that if current customers from improvements, the cost of those improvements would be allocated to them proportionately. 105 Wn.2d 293. Title 54 RCW, relating to public utility districts, does not include any language expressly authorizing PUDs to impose connection charges that include the cost of future facilities. In Hillis II, the court relied on PUD authority contained in RCW 54.16.030 to "sell and regulate and control the use, distribution, and price [of water]," and on the authority contained in RCW 54.24.080 to establish, maintain, and collect rate or charges for . . . water and other services, facilities, and commodities sold, furnished, or supplied by the district . . ." 105 Wn. 2d at 297-98. The court in Hillis II gave significant weight to the fact that the Snohomish PUD had carefully developed its connection charge based on the actual cost of future facilities allocable to the new hook-ups. The court noted that "the connection charges pay for

only those improvements to the water system necessitated by the new customers, and hence will benefit them alone, and the remaining improvements are paid for by rate increases imposed on all customers." 105 Wn.2d at 300.

Hillis II was expressly relied upon by the State Court of Appeals (Division I) in Lincoln Shiloh Assoc. v. Mukilteo Water District, 45 Wn.App. 123 (1986). In that case, a developer challenged a water district's general facilities charge as being unreasonable and discriminatory. The Court of Appeals upheld the charge noting that the district's engineers had carefully developed the fee based on actual costs expected to be incurred in order to serve the new customers. Citing Hillis II, the court held that "[i]f connection charges pay only for improvements necessitated by new customers they are not discriminatory." 45 Wn.App at 129. The court stated that the general facilities charge had been adopted in conformity with generally accepted practices in the water industry and that it could "be inferred from the findings, and the findings support the inference, that the general facilities charge was created to pay for improvements necessitated by new customers." 45 Wn.App. at 130. Note that a general facilities charge including cost of future facilities was upheld in Lincoln Shiloh Associates in 1986, before the adoption of Chapter 389, Laws of 1989, i.e. before the adoption of the statute that expressly granted authority to water districts to include the future costs of facilities in general facilities charges. We have reviewed the legislative staff analyses of Chapter 389 and the minutes of hearings before relevant committees of the legislature. That legislative history of Chapter 389 indicates that the bill was amended during consideration to add criteria for calculating connection charges and to limit the number of years of future costs that could be included in capital facilities charges. Without the ten-year restriction, there would be no restriction on the number of years of planned facilities that could be taken into account.

Hillis II and a number of other Washington cases have placed the burden on a person challenging utility charges to show that the charges are unreasonable. Hillis II, 105 Wn.2d at 300; Faxe v. Grandview, 48 Wn.2d 342, 352 (1956); Shiloh, 45 Wn.App. 123, 129 (1986); Geneva Water Corp. v. Bellingham, 12 Wn.App. 856, 862 (1975). Nevertheless, in our view it is very important that in developing capital facilities charges, careful attention should be paid to projecting the overall cost of improvements, the capacity of the improvements, the necessity of the improvements to serve new customers, and in demonstrating the direct link between the amount and cost of the improvements and the necessity of those facilities to serve the customers who are being charged for their development (*i.e.*, the marginal capital cost of the new hook-ups). After engineers and financial consultants have adequately developed that information, a city council or board of commissioners may rely on those professional studies in setting facilities charges that include future capital costs.

It has been suggested that the case of Boe v. Seattle, 66 Wn.2d 152 (1965) requires that express statutory authority exist for any type of utility rate or charge, including a capital facilities charge that includes the cost of future facilities. However, Boe, in which the State Supreme Court ruled against the City of Seattle's allocation of certain trunk sewer charges, appears to have been based on the fact the city had made "no effort . . . to determine what the cost of construction of the sewer system was or even the cost of constructing the trunk sewer abutting plaintiff's property in order to establish a proper connection fee." Boe did not hold that the cities were without authority to charge

a connection fee; the court did rule that the fee had to be reasonable and had to based on appropriate engineering and accounting studies, none of which had been adequately performed in that instance. Boe underscores the importance of sound studies prior to the adoption of connection charges, but the ability of a local government to include future costs and connection charges, even without express statutory authority, was clearly upheld 20 years later in Hillis II.

In considering what type of future facilities component should be included in connection charges to pay for water supply facilities acquired by a regional water entity, it is still necessary to take into account the ten-year limitation imposed on water districts by RCW 57.08.010(3). Although cities are not limited to ten years of future facilities when developing capital facilities charges, it might be difficult to justify the use of a 20-year planning horizon for cities that participate in regional water entity, while using a ten-year capital facilities planning period for water district members. In other words, from a practical standpoint (and perhaps a legal standpoint) both cities and water districts will be limited to a ten-year capital facilities planning horizon in developing a capital facilities charge for all participants in a regional water supply entity. If IWG members desire to use a longer planning period, such as the 20-year planning horizon used in regulations promulgated under the growth management (see, RCW 36.70A.070; RCW 36.70A.110(2); WAC 35-195-315(2)(b)), the IWG should seek appropriate changes to the statute that places the ten-year limitation on water districts.

I hope that this discussion is useful to members of the consulting team and to local officials working on the regional water supply effort. If I can be of any additional assistance concerning this matter, please do not hesitate to call.